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IWS Issue Briefs

The Disappearing Pension Act

Let's say you're planning to retire in ten years or so and you figure the "three-legged stool" of retirement security -- company pension, personal savings, and Social Security -- will sustain the quality of life you've worked hard to create. Well, like the pilots at US Airways and plant workers at Bethlehem Steel, you may need to recalibrate your plans. Your employer could declare bankruptcy and bail out of its pension obligations, the value of the underlying assets could plummet, or the company could freeze, reduce, or simply terminate its retirement benefits package altogether. If you happen to work in one of the "old economy" industries, such as heavy manufacturing or transportation, your situation may be especially dicey.

Indeed, for a growing number of American workers, the prospect of a financially secure retirement is becoming ever more remote. For one thing, Americans do not save enough. This long-standing pattern of behavior reflects both the ongoing joy of consumerism and artifacts of the most recent recession, including stagnant wages and disappearing jobs. Moreover, the foundation of the Social Security system is cracking. Conceived as a pay-as-you-go program, there is no "savings account" from which to pay benefits: Social Security uses the taxes of active workers to pay the benefits of retired workers. But the ratio of active workers to retired workers has been plummeting for years – it now stands at 3.3-to-1 compared to 16-to-1 in 1950 – and Congress will soon have to consider a variety of unpopular repairs, such as raising the normal retirement age from its current 66, boosting taxes, and/or reducing benefits.

Still, the shakiest piece of the retirement edifice is the private, employment-based pension structure. In the years following World War II, many American companies – especially large employers and those with unions – set up *defined benefit pension plans*. These plans promise employees a fixed monthly retirement income based on a formula that rewards seniority and heavily weights salary levels during the final years of employment. Defined benefit plans have been a vital piece of employers' human resources strategy: they facilitate recruitment and retention, and at the appropriate moment, severance through retirement. The average pension benefit is about 45% of salary, although a few fortunate retirees with many years of service receive benefits nearly equal to their salaries. Most existing defined benefit plans are funded entirely by employers through tax-exempt contributions and automatically cover all "qualified" employees (part-time employees and independent contractors are typically excluded). Some plans welcome, but do not require, additional contributions by employees.

Employers are under no obligation to provide pension benefits, but those that do must abide by certain laws and regulations. The Employee Retirement Income Security Act, popularly known as ERISA, sets standards about information sharing with plan beneficiaries and specifies fiduciary responsibilities for plan managers. The Pension Benefit Guaranty Corporation (PBGC) is a non-profit entity created by ERISA to insure all defined benefit plans; when a plan is terminated because the company is in financial trouble and the plan’s assets fall short of the promised benefits, the PBGC takes responsibility for the payments. Complex funding rules determine the timing and size of company contributions. Nonetheless, economic ebbs and flows and problems inherent in the rules themselves lead to periods of plan surpluses and plan deficits.

The PBGC’s own assets derive largely from employer premiums: $19 a year for each active and retired employee covered by the plan, plus additional fees if the plan’s assets are much lower than its liabilities. At last count, the PBGC insured 32,000 plans that included 44 million active and retired workers and had taken over 3,287 terminated pension plans that cover 934,000 current and future retirees. In 2003, the PBGC paid about $2.5 billion in benefits; that number is expected to jump to $3 billion this year.

Although workers are assured ongoing benefits when the PBGC steps in, beneficiaries often pay a steep price for their employers’ failure (or inability) to maintain adequate pension reserves. Benefit maximums are set by Congress, with the upper limit now at $3,699 a month ($44,386 a year) for workers who retire at age 65. Once the PBGC takes control, monthly payments may fall below promised amounts. Consider the pilots as US Airways, which declared bankruptcy in 2002 and terminated its defined benefit plan in 2003. Now that the plan has passed into the hands of the PBGC, the annual pension for retired pilots tops out at $28,585. Federal law requires pilots to retire at age 60, which automatically reduces their payments from the PBGC. For most retired pilots, the PBGC benefit is just a fraction of the sum they would have collected from the company plan.

At their peak in the mid 1980s, defined benefit plans covered about 40% of private-sector workers through 112,000 different plans. But the popularity of defined benefit pensions has waned, with a particularly steep falloff registered during the 1999-2002 period. Today, barely one-fifth of the active private sector workforce holds claim to a defined benefit pension.

Shaky Pension Structure. Part of this reversal of fortune reflects employer resistance to the growing financial burden of defined benefit plans. In single-employer plans, employers bear all the risk of managing the plans to meet their benefit obligations. (In industries where workers have multiple employers and are represented by a union, as in construction and trucking, pension plans are jointly managed by the union and the employers; the plan trustees bear the risk.) Employers contribute all the funds, determine the investment strategy for fund assets, and make the benefit payments. When the economy is strong and financial markets are robust (generating high returns on investments), employers can easily satisfy their funding obligations. Indeed, the overheated economy and bull market of the 1990s left most plans with a sizeable surplus (i.e., the “present” value of plan assets in today’s dollars is more than sufficient to cover benefits promised to current and future retirees). But when the economy softens and financial markets decline, plan assets shrink in real terms and the resulting underfunded liabilities loom as a giant drag on the corporate balance sheet.

And that’s where we find ourselves today. Falling stock prices during the 2000-2002 bear market coupled by historically low interest rates depleted pension assets and left many plans underfunded. But persistent weakness in the economy strained companies' cash flow and hindered their ability to pump funds into the asset base. By the end of 2003, the gap between assets and liabilities stood at $279 billion for plans that were at least $50 million in the red; analysts estimated the gap for all defined benefit plans at about $400 billion. The predicament is especially acute for airline and steel companies, which last year reported $31 billion and $6 billion in unfunded obligations, respectively. In an attempt to cut their losses, some companies are voluntarily terminating their plans and paying out promised benefits in lump sums, others are seeking exemptions from legal funding requirements, and still others are walking away from their plans and dumping them onto the PBGC. In 2003, 152 employers did just that.

Uncertainty about the interest rate used to calculate the value of the assets at hand reinforces employers' skittishness about their pension commitments. Known as the "discount rate," this critical variable is a key determinant of the plan sponsor's required contributions. For years the relevant rate was a rolling four-year weighted average of the interest paid on 30-year U.S. Treasury bonds, a relatively stable and conservative benchmark. But the Treasury stopped issuing these bonds in 2000, and the resulting scarcity of the asset prompted a jump in prices and a parallel drop in the interest paid on the bonds. As the rate fell, so did the present value of pension plan assets, leaving a gaping hole that employers were expected to fill. With the economy ailing and balance sheets strained, employers began clamoring for adoption of a higher discount rate. Congress responded and allowed employers to use a higher rate to calculate the present value of their plans' assets. During 2002 and 2003, the permissible rate was up to 120% of the four-year weighted average of the 30-year Treasury bond rate; for 2004 and 2005, plan sponsors can use a rate based on investment-grade long-term corporate bonds, which typically exceeds that of long-term Treasury bonds. Economists figure that the higher corporate bond rate will lower plan liabilities by 6%-8% and thus reduce required cash contributions. What happens after 2005 is anyone's guess. Ongoing political wrangling in Washington has delayed adoption of a permanent fix to the discount rate quandary.

Employer anxiety about retirement obligations also reflects the onslaught of competition from low-wage foreign and upstart domestic rivals. These lithe challengers, with their lower operating costs and younger workforces, generally do not sponsor high-priced defined benefit plans. The Bureau of Labor Statistics reports that employers spent an average of $1.28 an hour (the equivalent of 4.1% of total compensation) on defined benefit plans in 2003. Costs are especially steep for auto producers, steel makers, the airlines and other old-economy employers with their large pool of retired workers, the advancing years of current workers, and a dearth of new hires. According to *Business Week* magazine, the cost of pension and health benefits for retired General Motors workers amounts to $1784 per car compared to less than $200 for Toyotas produced in the U.S. Today, each beneficiary of a defined benefit plan is supported by one active worker; in 1980, that ratio stood at 3.5-to-one. Not surprisingly, many employers would be relieved to shed the so-called "legacy costs" of their longer-lived retirees and aging workforces.

Ironically, defined benefit plans are falling out of favor with some segments of the working population. Geared to a labor market wherein workers maintained long-term relationships with one employer, the traditional plan no longer suits an economy increasingly characterized by fluid and flexible work arrangements. Defined benefit plans cannot be carried from job to job and so hold little appeal for younger workers, in particular, who have little experience with, or expectations of, job security. Sears Roebuck, for example, recently began phasing out its defined benefit program. The company noted that average seniority has dropped sharply, to 10 years now compared to 20 years in 1990, that employees prefer the portability of the new plan, and that the cost-saving change will sharpen its competitive edge against Wal-Mart. Employers, in general, also assert that younger workers are demanding upfront compensation rather than a vague and elusive pension they won't collect for years to come.

Solutions or More Problems? Clearly, the system is in need of reform. Alternative pension structures, such as *defined contribution plans* and *cash balance plans,* are only partial solutions. Defined contribution plans, a catch-all name for a variety of plan formats, typically involve employer and/or employee cash contributions (some employers contribute shares of company stock) into individual accounts that each employee controls and carries with him when the employment relationship ends. Employees choose from among a set of investment options and bear all the risk of managing their retirement accounts. The funds available at retirement depend entirely on the amount that has been contributed over the years plus the return on investment. Some investment strategies pay off and others do not. With defined contribution plans there are no guarantees and no insurance from the PBGC. Enron employees, for example, whose pensions were largely invested in company stock, lost their nest eggs when the company imploded and the stock tanked. Despite the inherent gamble in this format, defined contribution plans have plenty of adherents. Today, 62.5 million people participate in defined contribution plans compared to 14.6 million in 1977; participation is voluntary and about 25% of eligible workers opt out.

Cash balance plans, a hybrid version of defined benefit plans, debuted about 10 years ago. In this variant, employers make the contributions (sometimes augmented by employee contributions) and control investment decisions. Each employee is given an individual account whose assets accrue with contributions plus a specified rate of return. Plans are insured by the PBGC. Unlike the traditional pension, however, cash balance plans impose no risk on employers, avoid complex minimum funding requirements, and grow more evenly over the course of an employee's career (i.e., they are not backloaded, as are defined benefit plans). During the late 1990s, about 19% of the Fortune 1000 companies converted their defined benefit plans to cash balance plans. But for all their appeal, cash balance plans are the subject of intense controversy. Because of the loss of early retirement supplements and the way account assets are determined at the time of conversion, older workers may see the value of their benefits drop by as much as 50%. Several years ago a disgruntled IBM employee filed a class action lawsuit alleging age discrimination. The suit is wending its way through the court system and the Internal Revenue Service has stopped approving conversions.

All told, about half the workforce participates in an employment-based pension. But with uncertainty surrounding the viability of defined benefit plans, the risks attached to defined contribution plans, the cloudy future of Social Security, and Americans' disinclination to save, retirement analysts are concerned that old age may become fraught with anxieties about money and further strain overburdened and under-resourced social services. Proposals to shore up the retirement savings system have been floated, ranging from restructuring the financial underpinnings of the PPGC to calculating pension liabilities using interest rates that better match workforce demographics, making the rules that govern defined benefit plans simpler and more flexible, and encouraging retirement pools for small businesses. But given the volatility of the pension issue and the political and economic costs involved, no quick fix is on the horizon.

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